



Memorandum

TO: HONORABLE MAYOR AND
CITY COUNCIL

FROM: Scott P. Johnson
Ralph Tonseth

**SUBJECT: APPROVAL OF OWNER
CONTROLLED INSURANCE
PROGRAM FOR AIRPORT MASTER
PLAN PROJECTS**

DATE: March 11, 2004

Approved

Date

COUNCIL DISTRICT: City-wide
SNI AREA: N/A

RECOMMENDATION

Adoption of a resolution authorizing the City Manager (i) to procure from American International Group ("AIG") Owner Controlled Insurance Program ("OCIP") insurance coverage for Airport Master Plan Projects with the insurance premium of \$3,943,972; (ii) to determine the most cost effective method to establish a claims loss reserve in the amount of \$3,900,000 to pay deductibles by either the establishment of a letter of credit or cash payment and to enter into the agreements required to establish the claims loss reserve; and (iii) to procure builders' risk coverage and owner's protective professional indemnity insurance including contractor's pollution liability coverage with aggregate insurance premiums not to exceed \$1,350,000.

BACKGROUND

An interdepartmental team from the Finance, Airport and Public Works Department examined alternative ways to manage risks during construction of the Airport Master Plan projects, including security improvements to be constructed over the next three to five years ("Airport Projects") at the Norman Y. Mineta San José International Airport (the "Airport"). Together, this interdepartmental team has specifically evaluated whether the method known as an "Owner Controlled Insurance Program" is feasible for the project compared to a conventional insurance program. An Owner Controlled Insurance Program ("OCIP") is a single insurance program covering the construction job-site risks of the project owner, general contractors and all subcontractors associated with construction; specifically Commercial General Liability, Excess Liability, and Workers' Compensation. Under an OCIP, the owner (in this case the City)

arranges a master program to protect and manage risk for the parties involved in the project construction at the designated project site. The City has had good experience with OCIP programs on both the Joint Library Project and the Civic Center project.

Under conventional insurance programs, project participants (City, construction contractors, and subcontractors) separately negotiate individual insurance policies to mitigate risks associated with specific project roles. The City specifies minimum acceptable coverages, terms, limits and monitors compliance through the contract process. Premium and losses are handled by the individual insurers of each entity, and no single party collects insurance and loss data in the aggregate. Since each contracting party procures separate insurance policies, the possibility exists for overlapping coverage, gaps in coverage, coverage/claims disputes and unrealized economies of scale. The cost of these coverage disparities is ultimately borne by the City in higher project costs.

Airport OCIP Feasibility Study - In 2000, as part of the Airport Master Plan planning efforts, the Airport commissioned Ron Rakich and Associates to prepare an Owner Controlled Insurance Program (OCIP) Feasibility Analysis to review the potential of using an OCIP for the Mineta San Jose International Airport Master Plan program. The initial report was issued in February 2001. The report details the various advantages and disadvantages to using OCIP as compared to conventional insurance programs and provides a timetable and strategy for OCIP implementation. The Feasibility Analysis was updated and revised in August 2003 to incorporate a revised Airport Master Plan scope and schedule, as well as to update information regarding the current insurance and economic markets relevant to insuring a major public works construction program.

OCIP versus Conventional Insurance - The OCIP Feasibility Analysis concluded that an OCIP is both economically and strategically feasible for the Airport Master Plan Projects. The primary benefits of an OCIP include:

- **Improved Coverage** -- An OCIP offers a single program to insure all parties and includes policy limits specific to the project. Higher limits of coverage are often available to an owner. In a conventional insurance program each contractor secures insurance under the specifications provided in the contract – coverage, terms, etc., however limits for some contractors and subcontractors, due to the size of their company may not be able to secure sufficient coverage within the City's required limits. Conventional insurance limits of \$1 million to \$15 million are common in California. An OCIP provides the opportunity, through economies of scale, to secure higher limits. The proposed Airport OCIP secures liability coverage limits up to \$150 million. This is a significant advantage to the contractors, subcontractors and the City in mitigating liability risk.
- **Control** -- In an OCIP, uniform safety standards are set for the project through a master safety program that establishes minimum standards for all contractors and subcontractors. Safety is coordinated with owner (the City), construction manager, insurance provider, insurance broker, contractors and subcontractors. Reducing losses, aside from providing costs savings, also reduces delays and cost overruns. Prior data reviewed in the OCIP

Feasibility Analysis shows that OCIPs average losses are 10% to 30% below average losses under conventional programs.

- **Management** -- With an OCIP, Workers' Compensation and Liability claims are handled with one insurer, saving time and costs. After an injury has occurred, proactive management programs return employees to work as soon as possible. The investment community tends to view an OCIP covered project favorably due to the increased certainty of knowing that a large-limit, broad coverage insurance program backs the project and thus reduces the probability of delay or failure. Owner control and management also allows for smooth transition from construction insurance to operation insurance, as there are relatively few claims disputed by two sets of insurers and determining whether a loss is due to construction or operation is not always easy. An OCIP provides increased initial administration, which comes at a cost, however in comparison; effective risk management of a conventional program requires significant ongoing negotiations and monitoring of contractor insurance coverages.
- **Cost Savings** -- OCIP savings may occur several ways. First, cost savings result from economies of scale and overhead related to insurance paperwork, claims and safety requirements. Second, an OCIP generally reduces losses due to the control elements produced by the program in management, training, safety, and documentation. And finally, consolidated coverage eliminates many of the cross-actions and disputes between parties. The cost of litigation and delays caused by insurance disputes from contested claims and disputes between insurance carriers in a conventional insurance program often add hidden costs and delays to the project.

Airport Master Plan North Concourse Project and OCIP - The Airport's Master Plan North Concourse Project, as a stand-alone project, was deemed to meet State law requirements to utilize an OCIP which include: a construction cost of at least \$50 million, as well as the determination that the implementation of an OCIP will minimize the expenditure of public funds in conjunction with providing the appropriate level of risk management. In addition, State law requires that potential construction bidders meet determined safety requirements and that bid documents notify potential bidders that an OCIP has been procured and minimum safety requirements must be met. The Department of Public Works has and will include these requirements in bid packages for OCIP projects.

Summary of OCIP Benefits to City - The benefits to the City for implementing an OCIP program for the Airport Master Plan Projects are significant. In the case of conventional insurance, the City may receive between \$1 million and \$15 million in general liability coverage from each contractor on the project. The OCIP, as recommended in this report, provides \$150 million of General Liability coverage along with ten-years of completed operations coverage. These OCIP insurance limits and coverage are cost prohibitive for individual contractors in today's insurance market. The ten-year completed operations benefit provides the City with liability coverage for injury or damage as the result of faulty construction work for the period of ten years post construction completion. An additional benefit to the City is cost savings from economies of scale due to the size of the program (volume purchase) and the market leverage in

procuring the OCIP insurance coverage. The City also eliminates the contractor mark-up for overhead and profit on their individual insurance premiums. The deductible of \$250,000 per occurrence, also allows for lower premium costs. The City, through the construction manager, will establish a coordinated safety and claims program to prevent and manage job-site related injuries more efficiently. These activities all translate into lower premium costs, greater savings and a higher level of safety standards for those working on the job site.

Insurance Broker Services - On November 4, 2003, City Council authorized the City Manager to enter into an agreement with Gallagher Construction Services to provide insurance broker services for an OCIP for Airport Master Plan Projects. During the past three months, various City staff from the Finance Department, Airport, and Public Works have worked with the broker to market the Airport North Concourse Building project and procure insurance bids. The analysis that follows provides an overview of the process, the bid, as well as the insurance coverage offered.

ANALYSIS

OCIP Insurance Procurement Process – Subsequent to City Council approval on November 4, 2003, the City and Gallagher developed a timetable and process for soliciting competitive insurance quotes for the Airport OCIP. As part of this process, Gallagher performed a risk assessment of the North Concourse Building project in order to prepare comprehensive specifications to be submitted to the insurance marketplace for insurance quotations. An Underwriting Submission was developed for the project that outlined coverages, terms and conditions, and timelines for submitting quotations. The Project Underwriting Submission and Risk Assessment documents were released to the marketplace on November 25, 2003. The following insurance carriers, who are the only insurance carriers currently offering OCIPs in the United States, were sent the specifications: Ace Insurance, American International Group (AIG), Arch Insurance Group, Liberty Mutual, Allianz, St. Paul, and Zurich. A pre-proposal conference and site visit were held for all prospective bidders on December 11, 2003. Following the site visit, additional information was provided to all of the carriers, including a draft safety manual and the North Concourse Building project schedule.

Due to the compressed timeline and the holiday season, none of the carriers were able to meet the initial December 23, 2003 deadline for submission of insurance quotes and the deadline was extended to January 15, 2004. OCIP quotes were received from the following insurance carriers: American International Group (AIG), Ace Insurance, Liberty Mutual and Zurich. Two carriers, St. Paul and Arch were unable to submit quotations in time to meet the revised deadline. Allianz indicated that they could only provide terms on the builder's risk coverage after the final design was complete.

OCIP Insurance Evaluation Criteria – The insurance quotes were evaluated based upon coverage limits, coverage terms, loss control and cost. Based upon these criteria AIG’s bid was determined to provide the best risk management and financial management features to the City.

| Carrier | General Liability and Employers Liability Limits <i>all Carriers offered Statutory WC Coverage</i> | Coverage Term Completed Operations | Loss Control | Cost General Liability, Employers Liability and Workers Compensation |
|----------------|---|---------------------------------------|-----------------------|---|
| AIG | \$2M/\$4M and \$2M/\$2M | 10 Years | 2 Site Visits/Month | \$6,090,943 |
| Liberty Mutual | \$2M/\$4M and \$1M/\$1M | 5 Years | 1.5 Site Visits/Month | \$10,102,630 |
| ACE | \$2M/\$4M and \$1M/\$1M | 5 Years | 1 Site Visits/Month | \$6,341,713 |
| Zurich | \$2M/\$4M and \$1M/\$1M | 5 Years | 1 Site Visits/Month | \$8,180,691 |

- **Coverage Limits** – Although all carriers offered General Liability Coverage limits of \$2 million per occurrence and \$4 million aggregate, AIG was the only carrier that offered \$2 million in Employers Liability coverage. The three remaining insurers quoted limits of \$1 million. \$150 million in Excess Liability insurance coverage is available from AIG at a cost of \$1,706,180. This is a significant benefit of the OCIP program since it would be nearly impossible for any contractor to obtain this level of coverage, but is so valuable to the City in an Airport construction setting where risk protection against a catastrophic incident is critical.
- **Coverage Terms** – Another critical feature of the AIG quote was the General Liability coverage term for completed operations at the policy limit of 10 years. Each of the other carriers quoted 5 years post project completion. In those cases the City would be uninsured for losses due to faulty workmanship by the contractors in years 6 - 10 post project completion. The ten-year completed operations benefit provides the City with liability coverage for bodily injury or property damage as the result of faulty construction work.
- **Loss Control** – AIG included two (2) site visits per month, Liberty included 1.5 visits per month and ACE and Zurich include one (1) site visit per month in their quote.
- **Cost** – Primary General Liability and Workers’ Compensation price quotes (less taxes) ranged from a low of \$6,090,943 to a high of \$10,102,630, with AIG being the lowest cost to the City.

The following is a summary of the proposed program with AIG for the OCIP policy:

| Coverages | Limits | Deductible | Estimated Premiums* |
|--------------------------------------|---|--------------------------|---------------------------|
| General Liability | \$2 million per occurrence/ \$4 million / aggregate for GL | \$250,000 per occurrence | \$522,346 |
| Workers Compensation | W/C – Statutory Employers Liability - \$2 million per accident | \$250,000 per occurrence | \$1,715,446 |
| Excess Liability | \$150,000,000 | | <u>\$1,706,180</u> |
| Sub-Total OCIP | | | \$3,943,972 |
| Claims Loss Reserve | | | \$3,900,000 |
| Maximum Premiums & Losses | | | <u>\$7,843,972</u> |

* Premiums, including taxes at maximum losses and without further negotiations are subject to actual payroll audit at end of project. Premium includes both the initial premium payment of \$3,943,972 and a claims loss reserve/loss fund totaling \$3,900,000.

The OCIP term includes a 36-month construction period with 10-years completed operations for the general liability. If construction were delayed beyond the 36-month construction period, the City would need to renegotiate with AIG for an extension of coverage at premium rates to be negotiated at that time.

OCIP Claims Loss Reserve Fund - In addition to the insurance premiums of approximately \$3.95 million for the Workers' Compensation, General Liability primary and Excess Liability coverage, the City is also required to establish a claims loss reserve fund in the aggregate principal amount of \$3.6 million with an additional \$300,000 available in a cash working fund. The claims loss reserve is used to fund the deductible amount of up to \$250,000 per occurrence, subject to an aggregate maximum loss exposure within coverage limits to the City of \$3,900,000. This is the aggregate amount, based upon initial payroll estimate of \$34.9 million. If the payroll increases, this aggregate amount will "float" upwards.

At the time of an accident, the adjuster sets up a reserve in the estimated amount in the adjuster's judgment that the claim will ultimately cost. This amount is held in reserve until either paid out or until the claim is closed. At the end of the OCIP program period, an actuarial review is conducted based on the claims outstanding and a portion of the unused amount is returned to the City, until all claims are closed and the coverage term ends. To the extent there are minimal claims/reserves, the amount of the returned loss reserve fund is greater. Under this policy the maximum exposure loss to the City for Workers' Compensation (with a payroll estimate of \$34.9 million) and General Liability is the claims loss reserve fund deposit of \$3.9 million.

AIG's quote provides for three options available for funding of the claims loss reserve; cash, letter of credit or a security trust. The City is required to fund the claims loss reserve with two deposits, the first deposit of \$1.95 million is due at binding of the insurance and the second deposit of \$1.95 million is due one-year later. City staff are evaluating the benefits and cost associated with obtaining either a letter of credit for the claims loss reserve or funding with a cash reserve. The term of the Claims Loss Reserve is up to thirteen years (three year construction period, plus ten years of completed operations). If the Claims Loss Reserve is funded with cash, AIG will perform an actuarial review to determine if funds can be released to the City prior to the end of the thirteen-year period. Interest will be credited to the Claims Loss Reserve Fund based on the rate set on the date of binding the coverage and each one-year anniversary date based on the rate paid on one-year U.S. Treasuries.

The City will be required to execute a payment agreement with AIG. The payment agreement specifies that disputes are subject to binding arbitration by a three member arbitration panel. AIG and the City each select one arbitrator and then those arbitrators select the third. In the event that the two arbitrators cannot agree, the parties must apply to a superior court in New York State to appoint the third arbitrator. Typically, the City does not agree to binding arbitration provisions or the laws of another state as these limit the City's options to pursue its rights. City staff has been informed that the insurer will not agree to eliminate either of these provisions. In light of the benefits to the City from the OCIP offered by AIG, staff recommends that the City accept these provisions.

Additional Insurance - In addition to the OCIP, the purchase of two additional insurance policies: Builders' Risk and Owner's Protective Professional Indemnity including Contractor's Pollution Liability (OPPI) are recommended at this time to provide risk management for the Airport Master Plan Projects.

- **Builders' Risk** – Builders' Risk insurance covers fire, extended coverage (coverage for property damage caused by windstorm, hail, smoke, explosion, riot, riot attending a strike, civil commotion, vehicle and aircraft collision), vandalism, as well as other defined coverages subject to the construction limit of this project of \$142 million. Limits are calculated based on the proposed construction cost plus additional costs that could be incurred in the event of damage to the structures, such as demolition costs or additional design costs. The City will additionally need to extend coverage in the Builders' Risk insurance coverage to include business interruption insurance to cover the City's debt service payments to bondholders to the extent the loss occurs prior to occupancy and after exhausting the capitalized interest funded from bond proceeds. The Builders' Risk policy will be procured after more information is available regarding the nature of the design and construction of the North Concourse Project, this will enable the City to received the most aggressive pricing for the Builders' Risk Policy. The total cost of this insurance policy is estimated to be \$550,000.
- **Owner's Protective Professional Indemnity including Contractor's Pollution Liability (OPPI)** – Owner's Protective Professional Indemnity including Contractor's Pollution Liability coverage protects the City in the event of potential damages arising from design

errors and omissions and provides a source of funds for City claims against project architects and engineers. The policy applies only after the design professional's own insurance has been exhausted or does not cover the loss. Additionally, the OPPI policy affords coverage for liability arising caused by pollution conditions arising from covered operations at the project site. This policy can only be purchased after the completion of the conceptual design of the North Concourse Building project. The estimated cost of this insurance coverage is \$800,000.

It is recommended that the City Council delegate to the City Manager the authority to procure these additional insurance policies at a premium cost not to exceed an aggregate of \$1.35 million for both the Builders' Risk and OPPI and Contractor's Pollution Liability.

North Concourse Building Project Safety Program – When City Council approved Gallagher Construction Services as the OCIP broker for the Airport Master Plan Projects, the staff report included a brief discussion of the development of a safety program, which would include evaluation and incorporation of safety services provided by Gallagher (insurance broker), the insurance provider, the City and the construction manager, Gilbane Building Company. The report also clarified that as with any construction project the responsibility for ongoing safety resides both legally and contractually with the project contractors. The following provides additional details and elements determined to be essential for a successful safety program for this project.

An evaluation of the safety management program took place with various stakeholders, and a Master Safety Plan, with Gilbane providing safety administration for the program has been developed. The identification of Gilbane as the Project Safety Administrator was based on experience, expertise, cost, management practices, staffing commitment and clear communication of responsibilities for the entire project. During the course of the OCIP risk assessment and marketing process it became very clear that Gilbane is recognized as a leader in construction safety. Gilbane brings to the table many years of experience working with OCIPs. Their knowledge of best practices and commitment to safety was a beneficial factor cited in the development of insurance quotes for the North Concourse Building project. In addition, the incentive to complete the project on time and on budget is clearly dependent on running a safe and secure job site.

The North Concourse Safety Program consists of the following four key elements:

- **Contractors** - The primary responsibility for safety resides with each individual contractor and subcontractor. Each is required to submit a site-specific safety program to be reviewed and approved by Gilbane and the City. Each contractor and subcontractor will identify a Safety Officer who is responsible for safety training, coordination, communication and insuring that work by that contractor is conducted in a safe manner and in conformance to Cal/OSHA requirements and all other applicable Federal State and Local requirements, as well as the North Concourse Master Safety Plan.

- **Construction Manager - Gilbane Building Company** will provide a full-time Safety Officer supported by technical administrative staff to direct and monitor the safety components of the OCIP program. Gilbane, under the direction of the City, has developed the Mineta San Jose International Airport North Concourse Master Safety Plan, which provides detailed direction on the policies and procedures for prevention of injury, property damage, fire damage and occupational illness for this project. Gilbane will insure that each individual allowed on the project site goes through a thorough safety orientation and is “badged” before being allowed on the worksite. Gilbane will also provide monthly safety oversight by their regional safety officer.
- **OCIP Broker, Gallagher and OCIP insurance carrier, AIG** will provide monthly monitoring of the safety aspects of the OCIP program.
- **The City** – Airport, Public Works and the Finance Department each have a role to play in ensuring that safety policies and procedures are in place and fully engaged in all phases of construction and planning. Through coordination and the development of contracts, schedules, manuals, trainings, and reporting, the City will direct and monitor project elements to ensure that this project is successful in all areas including safety.

PUBLIC OUTREACH

Public outreach is not required for this action.

COORDINATION

This report has been prepared by the Finance Department and the Airport in coordination with the City Manager’s Office, Public Works Department, City Manager’s Budget Office, and the City Attorney’s Office.

COST IMPLICATION

Cost associated with the OCIP, and other insurance policies included in this memo, are fully related to the Airport Master Plan North Concourse Building project and are included in the project costs in the Airport Capital Improvement Fund (Fund 520) and the Airport Revenue Bond Improvement Fund (Fund 526). The following table provides a summary of the total not to exceed premiums for each component of insurance. Both the Workers’ Compensation and Commercial General Liability premiums are subject to final audit by the insurance carrier, subject to adjustment based upon total payroll and construction value respectively. To the extent that total project payroll exceeds the initial estimate of \$34.9 million or construction values exceed \$142 million, additional premiums may be due upon completion of the project.

| <u>Insurance Policy</u> | <u>Estimated Premiums</u> |
|--|---------------------------|
| OCIP - Workers' Compensation | \$1,715,446 |
| OCIP – General Liability – Primary Layer | 522,346 |
| OCIP Excess Liability | <u>1,706,180</u> |
| Subtotal OCIP Premiums | \$3,943,972 |
| Builder's Risk | \$ 550,000 |
| Owner's Protective Professional Indemnity & Contractor's Pollution Liability (1) | <u>800,000</u> |
| Subtotal Insurance Premiums | \$5,293,972 |
| Claims Loss Reserve (2) | \$3,900,000 |
| Total Insurance Costs | <u>\$9,193,972</u> |

(1) To be procured after completion of conceptual design of North Concourse Project

(2) This reserve is established as described earlier. To the extent funds are not required to fund losses, the balance is returned to the City at the completion of the OCIP program.

Consistent with the Council Budget direction, this Project has a neutral impact on the General Fund, and spurs construction spending to help local economic recovery. The City will issue commercial paper from the Airport's commercial paper program in order to fund a portion of the cost of the insurance referenced above.

BUDGET REFERENCE

| Fund # | Appn. # | Appn. Name | RC# | Total Appn. | Amt. for Insurance | Adopted Budget Page | Last Budget Action (Date, Ord. No.) |
|---------------|----------------|--------------------------|--------------|----------------------|---------------------------|----------------------------|--|
| 526 (548) | 4657 | North Concourse Building | TBD | \$242,309,000 | \$8,429,033 | Page 65 | 10/14/03 No. 26997 |
| 520 | 4657 | North Concourse Building | TBD | \$21,989,000 | \$ 764,939 | Page 65 | 10/14/03 No. 26997 |
| | | | Total | \$264,298,000 | \$9,193,972 | | |

CEQA

CEQA: Resolution Nos. 67380 and 71451, PP04-02-042.

SCOTT P. JOHNSON
Director, Finance Department

RALPH G. TONSETH
Director, Airport Department

